GARS Case Study

Applying an Innovative Investment Solution to the Standard Life Staff Pension Scheme

Standard Life Investments

July 2016

Standard Life's pension problem

In 2005, the trustees of the £1 billion Standard Life Staff Pension Scheme faced a problem common to many defined benefit pension schemes. Up until then they had taken a traditional investment approach, with a high allocation to equities and a small proportion in bonds, property and private equity. However, several years of volatile markets had taken its toll and the Scheme was running an accounting deficit of around £200 million.

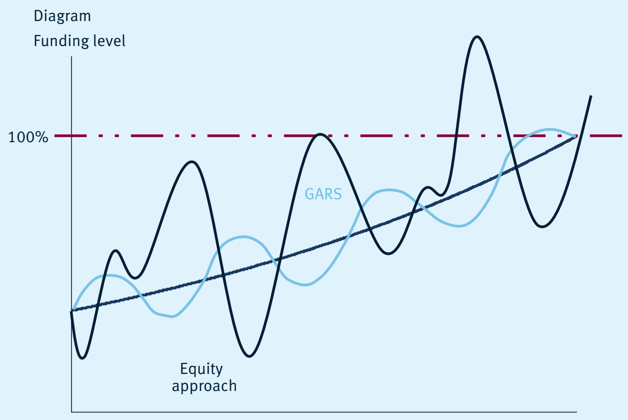
A solution was therefore required to both close the funding gap and to ensure the liabilities could be met on a more sustainable basis.

The decision-making process that followed involved several parties, each with different objectives.

- From the company's perspective, the staff pension scheme constituted a key risk to the balance sheet. Standard Life was set to demutualise and a large pension deficit could have threatened the company's ability to make dividend payments.
- The trustees' objectives centred on minimising funding risk and demonstrating a plan to close the funding gap.
- The investment manager (Standard Life Investments) was responsible for constructing and implementing a solution that could target a good return relative to liabilities but with less investment risk than the previous investment strategy that was heavily dependent on equities.
- The investment consultant was responsible for providing formal independent advice on the proposed structure.

Completely hedging all investment risks relative to liabilities was not an option – returns needed to be sufficient not only to cover the liabilities but to also improve the funding position while guarding against future market shocks. In response to the trustees' willingness to reduce risk, the company agreed to make substantial incremental payments into the Scheme. The solution would therefore need to meet future liabilities, keep contributions at a reasonable level and avoid excessive exposure to volatile asset classes.

Improving funding and reducing volatility



Source: Standard Life Investments

A practical solution

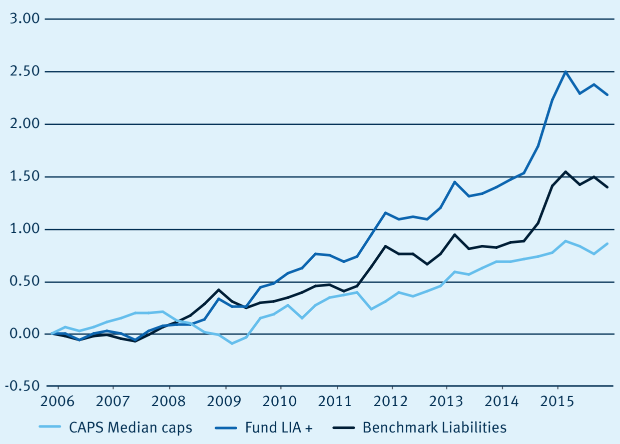
The solution proposed by Standard Life Investments marked a complete change of strategy from the traditional equity/bond approach. It involved the creation of a 'liabilities-plus' strategy, with a focus on outperforming liabilities rather than a benchmark index.

The trustees were understandably concerned about taking such a radically different approach – both in terms of where they had come from and because few pension schemes ran a similar strategy. Therefore, Standard Life Investments spent a significant amount of time working closely with the trustees explaining the strategy and its benefits in providing a smoother route to higher funding levels.

The chart shows how the strategy has subsequently performed relative to both its liabilities and the CAPS* median UK pension scheme. It can be clearly seen that the Scheme's assets have remained in touch with the liabilities, providing significant downside protection at a time when traditional risk assets performed poorly. Indeed, in 2008, when markets were particularly turbulent, the Scheme was the best performing FTSE 100 pension scheme**.

*CAPS: Combined Actuarial Performance Services
**Source: Lane, Clark & Peacock, Accounting for Pensions 2009 Survey

Liabilities plus strategy performance



Source: Standard Life Investments, as at 31 December 2015

Effective implementation

Step one — set the risk budget

For Standard Life Investments, the starting point in implementing the solution was to examine the Scheme's current position and identify the major risks (equity market, interest rate and inflation). In conjunction with the trustees, an overall investment risk budget was agreed and a target of liabilities +2.2% each year over rolling three-year periods was established, based on objective valuations and the liabilities deficit. The chart opposite shows the number of risks identified as well as the magnitude of each standalone risk factor.

Step two — reduce unrewarded risk

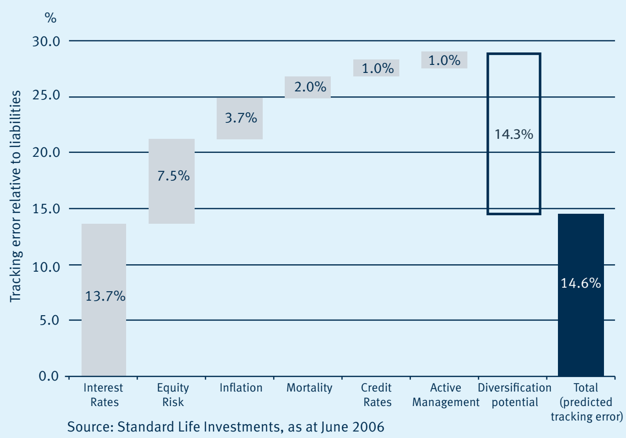
It was essential to distinguish between risks that were likely to be rewarded and those that were not. Where possible, the unrewarded risks would be removed or mitigated. Specifically, changes in interest rates and inflation, which affect the value of a pension scheme's liabilities, were considered the principal unrewarded risks.

The aim of the investment manager was to construct an asset portfolio with the same sensitivity to those factors as the liabilities. This would limit the differences between asset and liability movements, thereby reducing risk.

To construct this liability-hedging portfolio, the manager used a derivatives overlay to reduce the unrewarded risks. The extent of the risk reduction achieved is indicated by the numbers circled in red in the chart opposite. Interest rate risk, for example, fell from 13.7% to 5.4%.

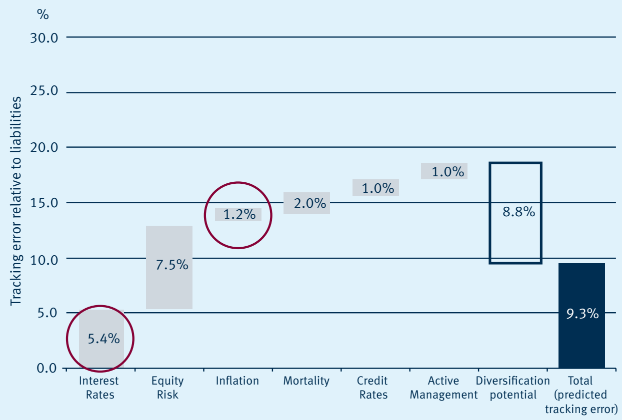
Crucially, the trustees allowed time and flexibility to build this hedge position and, as a result, the investment manager was able to execute transactions in the most efficient manner possible.

Identify the nature and magnitude of risk



Source: Standard Life Investments, as at June 2006

Reduce unrewarded risk



Source: Standard Life Investments, as at June 2006

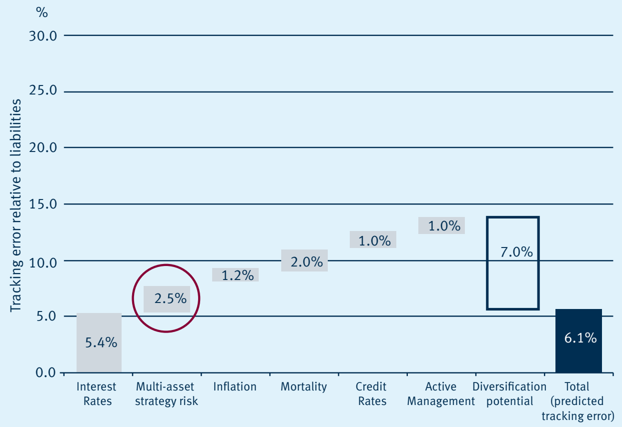
Step three — address equity market risk and implement a diversified growth portfolio

The next step was to reduce equity market risk while still seeking positive returns. The aim was to not only match the assets and liabilities to reduce unrewarded risk but also to generate some investment performance. This was crucial initially, to remove the funding deficit and provide a cushion against future market shocks. Rather than rely on the vagaries of stock markets to provide the targeted return we instead devised a highly diversified multi-asset solution, which sought to deliver a targeted return, within a specified risk budget. This approach utilised both the benefits of diversification and the fundamental strengths of Standard Life Investments' skilled portfolio managers.

Called Global Absolute Return Strategies, the solution aimed to deliver consistent investment returns at low levels of volatility compared with traditional asset classes. To achieve this, it invested in a broad range of investment opportunities covering both traditional and advanced asset classes.

The initial transition phase largely involved retaining the existing physical holdings while removing market risk through derivatives. Standard Life Investments then introduced a number of strategies that would help meet the return requirements. The number circled in red in the chart opposite highlights the resultant reduction in market risk – the multi-asset strategy risk was only 2.5% compared with a 7.5% equity risk shown in the chart above.

Address equity bias risk with multi-asset strategy



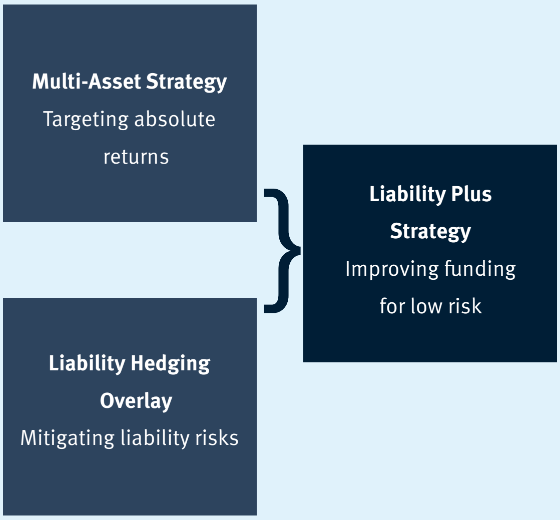
Source: Standard Life Investments, as at June 2006

Summary

It was clear to all parties that the Scheme's assets needed to deliver consistent growth in a risk-aware way. By working closely with the trustees to understand their requirements, Standard Life Investments was able to design and implement a distinctive multi-asset approach, aimed at helping the Scheme outperform its liabilities with low levels of risk.

The decision by the Scheme's trustees to implement this radically different investment solution has provided a lower-risk framework for the Scheme to meet its funding objectives.

Today, the Scheme is fully funded and the low-risk objective has been borne out in practice (actual tracking error versus the liability benchmark has been gradually reduced over the last 10 years, from around 8% per annum to around 3% per annum). The Scheme's funding level has also shown steady, sustained improvement over the period since the strategy's inception.



If you would like to find out more about Global Absolute Return Strategies, please speak to your usual contact at Standard Life Investments, or visit us online.

Visit us online

standardlifeinvestments.com

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Due to among other things, the volatile nature of the markets, the investment strategies discussed herein may only be suitable for certain investors.

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Standard Life Investments is engaged in a joint venture with HDFC Asset Management.
Standard Life Investments is engaged in a strategic alliance with Sumitomo Mitsui Trust Bank.
Standard Life Investments is engaged in a joint venture with SL Capital Partners (US), LTD.

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